

Energy insights:  
SEC's new rules for reserves reporting

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# Evolution to principles-based reserves reporting: New SEC rules require strategic direction

*Time is right to ensure that proper engineering, accounting policies and oversight are in place.*

By John Brady, Keith Rowden and Don Roesle

For more than 25 years, the SEC's rules for measuring and reporting oil and natural gas reserves remained relatively unchanged, despite increased geological complexity, significant advances in technology and increased price volatility in global markets. As time progressed, these rules eventually made it more difficult—not less—for investors and analysts to assess and compare the oil and gas that companies held underground.

Today, however, a new set of reporting principles—adopted in late 2008—will impact the way oil and gas companies communicate reserves information to stakeholders. The SEC's new rules give energy executives and directors the opportunity to more closely align reserves reporting with their overall business strategy and their competitive position in the marketplace.

The opportunity for change provided by the new rules—while welcomed—does not mean that companies are required to make wholesale changes in the way they estimate and report reserves. The rules do offer senior management an ideal opportunity to undertake a holistic evaluation of their organization's reserves reporting process and determine if changes are warranted.

Further, it provides senior leadership with a “defining moment” in which they can articulate a clear vision that defines how their organizations will measure and report reserves in a sound, consistent and transparent manner. In a new reporting environment that is driven by principles rather than rules, boards and senior management must take the lead in setting the structure and policies that ensure quality around reserves estimation and reporting. As we move closer to implementation, the “tone from the top” regarding reserves reporting will be as critical as ever.

# The new rules

The SEC's rule changes center on four key elements:

- Broadening of the technology standards that can be used to determine reserves quantities
- Elective disclosure of probable and possible reserves
- Adoption of a 12-month average price to determine reserves value, as opposed to the single-day, end-of-year price previously mandated; optional price sensitivities will also be permitted
- Including non-traditional resources focusing on the final product rather than the method of extraction

Right now, companies are still determining how they will respond to the changes approved by the SEC. There are many factors to be evaluated and a number of implementation questions still remain, including:

- What threshold should apply for technology to be proven reliable under the new rules? How many successful instances should be demonstrated to meet the reasonable certainty threshold? Does numeric modeling or pressure testing pass the test as reliable technology? What is the technological justification for booking PUDs beyond one offset? What level of disclosure surrounding proprietary technologies is enough?
- What are the risks of disclosing probable and possible reserves compared to the benefits of disclosing them? Is there increased litigation risk associated with disclosing other than proven categories of reserves should they prove to be materially inaccurate? Will probable and possible reserves that are reported outside of public filings need to be conformed to the new rules?
- Although the new rules specify the use of a 12-month average price to determine reserves value, they are silent on how the associated capital and operating costs should be determined. Is it the SEC's intention that such costs continue to be determined as of the end of the period consistent with the old rules or can companies use historical average or future cost assumptions? Will management avail itself to the optional reserves sensitivity analysis that the new rules permit?

- How will the new rules impact financial accounting and disclosure requirements required under existing generally accepted accounting principles? How will the impact of applying the new rules be disclosed? Will certain geological and geophysical costs now qualify for capitalization to the extent they result in reserve additions?

Even if companies can meet the technical hurdles to book reserves, they must still be able to demonstrate the intent and financial ability to develop them. In today's economic climate, the question of financial ability and corporate commitment to an adopted development plan for undeveloped projects is one that must be addressed before disclosing associated reserves. Additionally, ensuring that aging PUD reserves are a part of an adopted development plan is essential. Ensuring that the reserves will be developed is part of a company's reserves strategy and approach to a system of checks and balances regarding reserves reporting.

## Varying approaches may arise



Because the new rules open up an array of choices around reserves measurement, a critical first step for senior management is to determine the company's overall reserves reporting philosophy. This evaluation will be influenced by many factors including a company's unique reserves profile, its interpretation of measurement and reporting principles, consideration of peer group practices and, of course, the needs of its stakeholders.

Regardless of the path chosen, most companies will need to realize that the implementation of these new rules will be a learning process across the organization and that application of the principles will evolve over time.

## Governance continues to play an important role

As with the application of any principles based standard, a range of acceptable potential outcomes may result depending on the experience and judgment of those involved. There will be more pressure and responsibility on reserves engineers and third-party evaluators, who will in many cases be making more difficult judgment calls as to what reserves are acceptable. The qualifications of those making reserves reporting decisions and the internal controls and policies that guide them will be under increased scrutiny and should be understood by management and the board.

This is the perfect time to review the organizational structure of the reserves reporting group and re-evaluate related policies and processes. The goals of this review should be to ensure the effected functions are adequately staffed and trained, clearly delineate the company's reserves strategy and approach, and identify any possible conflicts that may compromise quality.

Many companies have significantly improved the governance of reserves estimation and reporting process in response to Sarbanes-Oxley requirements. However, these new rules should be an impetus to senior management to review this area of reporting—making certain the right expertise is in place; that board members receive the right amount of information; and that the board devotes an appropriate amount of time reviewing data once the new rules are in effect.

The board of directors and senior management should also consider whether the company's checks and balances system is strong, both to ensure that reserves are measured and reported accurately and to make certain that there is consistency in reserves determination and disclosure from year to year and comparability with industry norms.

The principles-based approach of the new guidelines also means that companies will need to be more transparent in their discussion of reserves estimates and disclosures to stakeholders by providing enough information to give investors and analysts a more thorough understanding of how they arrived at the numbers and the sensitivities associated with them, versus just an accounting of the numbers themselves

## What to consider

In order to properly prepare for compliance with the new rules, board members—especially those serving on the audit or reserves committee—and senior executives should be prepared to “dig deep” into the company’s reserves reporting function and determine that appropriate changes have been made.

Questions to consider asking include:

- Is there appropriate governance and oversight of the reserves estimation and reporting process?
- Is the organizational structure of the reserves estimation function appropriate? For example, does the chief reserve estimator report to an appropriate level within the organization? Is there separation of those responsible for reserves measurement from those responsible for adding reserves?
- Are estimates reviewed by employees with adequate training and experience in the new definitions and guidelines?
- Are compensation and bonus arrangements aligned with the company's objectives for insuring the integrity of reserves reporting?
- Are there written policies and procedures concerning the reserves estimation process with enough rigor to address the new principles based rules and ensure consistency across the organization and from period to period?
- Does the enterprise have the capability to adequately oversee the work of independent reserves estimators? Are those estimators independent? Are reserves determination and disclosure part of the company's overall risk assessment process?

## Leading the change

The SEC's new reserves reporting rules strive to better reflect the realities of today's oil and gas industry and provide an opportunity for companies to tell their unique stories to key audiences as it relates to their oil and gas reserves. This principles-based approach offers the opportunity to "customize" reserves reporting while still allowing investors and analysts to compare companies fairly. Senior management and those responsible for governance must play a role in leading this effort and ensuring that the path chosen is followed ethically, responsibly and consistently.

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Mr. John Brady is a Houston-based Partner in the PricewaterhouseCoopers energy practice and has served a wide variety of multinational public and private companies in the oil and gas exploration and production, petroleum refining, oilfield services and energy marketing sectors of the energy industry. He has substantial SEC reporting and technical accounting expertise specific to both independent and integrated oil and gas companies. As one of the Firm's oil and gas subject matter champions, Mr. Brady frequently consults with clients on transactions unique to the industry including joint ventures, production payments, accounting method conversions, business combinations and financial risk management activities. Mr. Brady has also assisted his clients in various acquisition due diligence reviews and numerous primary and secondary capital markets transactions. In addition to his client responsibilities, Mr. Brady also serves as the Technical Liaison Partner for our energy practice. In this role, he is responsible for coordinating the Firm's thought leadership initiatives and the sharing of knowledge across our energy practice.



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Keith is a senior partner in the PricewaterhouseCoopers energy practice with 30 years experience serving energy clients both abroad and in the US. In addition to serving clients, Keith has held a number of technical roles in the firm. From 2001 through 2004, Keith led the PwC Global Energy and Mining practice in Russia, Central and Eastern Europe, comprising of 230 dedicated staff and partners. From 1990 to 2001, Keith served SEC registered companies in the US, acted as a SEC consulting partner and an oil and gas consultant for PwC. From 1998 to 1990, Keith was a Practice Fellow at the Financial Accounting Standards Board (FASB) in Norwalk, Connecticut.



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Mr. Don Roesle is Chairman of the Board and Chief Executive Officer for Ryder Scott Company, L.P. He has over three decades of experience in the international oil and gas industry as a reservoir engineer, project manager and executive manager. As project manager, he has directed multidisciplinary project teams in numerous major integrated reservoir and field-development studies worldwide. Mr. Roesle began his career with Tenneco Oil Company as a drilling and reservoir engineer. He joined Ryder Scott in 1975 and is presently responsible for oversight of all the Company's operations in Houston, Denver and Calgary. Mr. Roesle works with the SEC and SPE/WPC reserve definitions daily and has developed deep knowledge of these definitions in the classification of reserves. Mr. Roesle has completed reserves certifications and economic evaluations for use in bank loan requirements, SEC filings, acquisitions and divestitures, estate-tax requirements, initial public offerings, internal company financial planning and various other projects. He is a registered Professional Engineer in Texas and a member in the Society of Petroleum Engineers, Society of Petroleum Evaluation Engineers, is a past member of the Industry Advisory Committee to the Department of Petroleum and Geosystems Engineering at the University of Texas and currently serves on the Engineering Advisory Board of the College of Engineering at the University of Texas.

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